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SUBJECT: GEORGIA: BIG SELL ON ECONOMIC REFORM UNDERMINED BY
ONGOING INVESTMENT ISSUES

Classified By: Charges d'Affaires a.i. Kent Logsdon for reasons 1.4 (b)
and (d).

1.(C) Summary: While some economic indicators may be slowly improving, Georgia's overall economic and business climate is looking increasingly bleak. At the same time that the President and Government are publicly touting new economic legislation to permanently institute the fundamental economic reforms of the past five years, disturbing steps are being taken that could negatively affect the overall business climate. Reintroduction of the financial police, increasingly draconian measures by the Customs and Revenue Service to add to rapidly dwindling government coffers, and allegations of high-level corruption are causing serious fear and uncertainty in the business community. Many believe that this disconnect in government words and deeds indicate a resource grab for an increasingly shrinking pool of resources. End Summary.

IS THE ECONOMY LOOKING UP?

12. (C) The government continues to closely watch consumer indicators, desperately looking for signs that the economy is improving. Based on figures provided by the Prime Minister's office, indicators such as the number of new car registrations and secondary property market transactions seem to show minimal signs of improvement. The director of ProCredit Bank, a large German microfinance bank, said that he has seen an increase in the number and quality of loan applications in the past two months. These indicators seem to show that the economy could once again start to move in a positive direction. The banking sector remains strong, although non-performing loans continue to pose a challenge. The vice president of TBC Bank, the second largest bank in the country, told us that his bank is sound and that GEL deposits in TBC currently exceed August 2008 pre-invasion levels.

GOVERNMENT REVENUES CONTINUE TO DECLINE

13. (C) This slight improvement in the economy has not yet registered in government revenue collection. Based on recent data, government revenues have fallen approximately 500 million GEL. This decrease is on top of an already significantly scaled back budget, which was amended in 2009 to meet financial realities. There is little fat left in the existing budget to cut if revenues do not increase, meaning social programs might need to be cut. The government has already been criticized by the IMF for running a nine percent budget deficit covered in large part by the recent issuance of treasury bills. There are now signs that the economy may contract by more than the 4 percent figure currently estimated by the Government.

ACT OF ECONOMIC FREEDOM

14. (C) The Georgian government recognizes that it must continue to show new economic reforms to attract international investors. In private conversations, former Prime Minister and now government advisor Lado Gurgenidze stressed that if Georgia did not find ways to institutionalize economic reforms and embark on a new series of structural reforms, it risked losing its reputation as an economic reformer and attractive place for investment. In response to these concerns, on October 6, President Saakashvili announced a new package of reforms that would include a constitutional bill to protect "freedom, opportunities, equality, and dignity." The main aims of the Opportunities, equality, and dignity." The main aims of the act are to create a "government of small size, low taxes, maximum freedom of citizens and entrepreneurs from government interference and bureaucratic discretion, opportunities for everyone, promotion of free economy, and transparent governance together with available education through increased social mobility." Concrete measures in the Act include a constitutional amendment that would mandate that total budget expenditures not exceed 30 percent of GDP. The budget deficit would be capped at three percent of GDP and gross national debt would be limited to no more than 60 percent of GDP. Additional clauses include protecting free convertibility of the currency; restricting the number of license and state regulatory bodies governing business; and prohibiting the state from holding shares in commercial banks. Saakashvili told the Parliament that this new act would make Georgia more attractive for investors and enable the creation of new jobs and employment opportunities for the people.

WHERE WORDS AND DEEDS DIVERGE

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15. (C) While this new push for economic and business reform is admirable, the reality on the ground does not always correspond to this "strategic vision." Business community leaders, both Georgian and foreign, privately note that they feel more vulnerable to government pressure now than in the past few years. In attempts to make up for revenue short falls, the Revenue and Customs Service of the Ministry of Finance has initiated an aggressive campaign of tax collection throughout the country. While tax evasion remains a problem in Georgia in some sectors, especially in services and restaurants, one local businessman stressed that the government has intentionally made the tax code ambiguous to allow them to crack down when needed. He added that if the government decides they want to target an individual for revenue collection, they can and will. The complexity and the ambiguity of the tax code, coupled with unprofessional and unsystematic advice from government tax officials, can make it nearly impossible to be in complete compliance. In addition, there are no regulations that establish when and how often the Revenue Service can conduct a tax inspection. When a tax investigation is initiated, the government simply shuts the business, not allowing commerce to continue. In a move the business community finds especially troubling, the government recently introduced an amendment to the tax code that allows the government to seize a company's assets after an initial court ruling, rather than waiting for the judicial process to run its course through the appeals system.

THE FINANCIAL POLICE RE-APPEAR

16. (C) In addition to the Act of Economic Freedom, the government has introduced other economic legislation to the parliament with considerably less, or no, fanfare. This includes a law that would allow for the re-establishment of the Financial Police under the Minister of Finance. The Deputy Minister of Finance, who oversees the Revenue and Customs Service, Zaza Chelidze, tried to allay the fears of the American Chamber of Commerce Board of Directors in a September 30 discussion. He stressed that the Financial Police, although disbanded several years ago, had continued

to exist in all but name. He said the Special Investigative Unit (SIU) of the Customs and Revenue Service had all of the same authorities, including the right to carry weapons that the new Financial Police will have. He added, however, that the lines of control and supervision were much less controlled and that the SIU had actually led to the "policification" of the Revenue Service. The AmCham Board remained skeptical and told Chelidze that the business community still vividly remembered the Financial Police as masked men with weapons who could raid businesses at will. They stressed that if the government was serious about protecting businesses, rights, they need to make the Financial Police as transparent and accessible as possible, while clearly defining its role and authority. The Prime Minister made the same pitch to the Charge, arguing that this was simply a bureaucratic change, not a sign of a new policy of forced collections.

HOW TO SPLIT A SHRINKING POT

¶7. (C) While in political fora the government continues to promote the free and liberal Georgian economy, behind the scenes we see growing evidence of the opposite tendencies. Influential business people have said that commodities, especially imported commodities, remain a place where a small group of the well-connected can continue to make money because of a lack of transparency in customs practices. Who exactly makes and controls this money and where it goes is unclear, although conventional wisdom seems to support that it goes to individuals with the support of the ruling party for a combination of personal and political purposes. An ongoing commercial case involving a U.S. company importing sugar has provided us with insight into the process.

SUGAR ISN'T SO SWEET

¶8. (C) The U.S. company in question started importing sugar into Georgia in early 2008 without incident. According to a company representative, it would usually take two hours to clear the cargo through customs and deliver it to the customer. However, in early summer, they received a "warning" that they should stop importing sugar. A shipment they received during this time period was subjected to an entirely new series of regulations and tests, and the company confronted a myriad of administrative barriers to trade while they tried to get their cargo released from the Port of Poti. After considerable U.S. government support, the shipment was

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released, though the company's local partner was charged with misclassifying sugar and subjected to a criminal trial. When the company's next shipment reached Poti in late August, they met with a series of additional delays. Despite U.S. government inquiries at senior levels in the government, the cargo has remained at Poti for over 30 days with no response to U.S. or company requests to explain why the cargo has not been released. This delay has cost the company to date over USD 15,000 in fines and demurrage charges. The Charge has raised this case with senior government officials up to and including the Prime Minister; thus far, all we have received are assurances that they would "look into the case."

MONOPOLIZING TO MAKE MONEY

¶9. (C) Several long-time resident American business people explained that this process of holding up cargo, especially commodities, as a way to deter competition in a market harkens to the bad old days. A local business leader said that individuals with ties to influential government officials can monopolize commodities and therefore control prices while skimming profits off the top. He specifically noted sugar, gasoline and oil products as prime targets. According to the American company importing sugar, in May, ten companies were importing sugar into Georgia, now there is only one local company - the Agara Sugar Company. This

company is understood by several businessmen experienced in Georgia to have strong ties with individuals within the ruling party, although the exact nature of these ties is unclear. The American company representative added that since this monopolization has occurred, the local price of sugar has more than doubled - an impact felt in the retail market by consumers as well.

COMMENT - WE WANT TO GET THERE BUT JUST CAN,T GIVE UP CONTROL

¶10. (C) Many in the government remain steadfastly dedicated to economic modernization and reform. They recognize that the way forward for Georgia is to further the unique Georgian business model, making it easy to invest and do business in a region historically known for corruption and red tape. Unfortunately, for a smaller group within the government and ruling party, the ever shrinking economic pie has lead to more aggressive measures to maintain the status quo. Unfortunately, whether these are corrupt behaviors or simply under-regulated over-aggressive tax police, the impact is the same and runs counter to Georgia's larger goals. Now is when the Georgian economy most needs transparency and to show that it is approaching western standards in both legislation and implementation. Doing this, will require serious political will to tackle entrenched interests in recognition of what is needed for the larger good of the Georgian people and country. Recent events indicate that this political will might be lacking, even though the government continues to talk a good game. Actions continue to speak louder than words. We must continue to press for economic reform in word and deed.
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